

**SECURITIES AND EXCHANGE COMMISSION**  
**Release No. 34-57301 / February 11, 2008**

**Order Granting Temporary Exemption of LACE Financial Corp. from the Conflict of Interest Prohibition in Rule 17a-5(c)(1) of the Securities Exchange Act of 1934**

**I. Introduction**

The Credit Rating Agency Reform Act of 2006 (“Rating Agency Act”),<sup>1</sup> enacted on September 29, 2006, defined the term “nationally recognized statistical rating organization” (“NRSRO”), added Section 15E to the Securities Exchange Act of 1934 (“Exchange Act”), and provided authority for the Securities and Exchange Commission (“Commission”) to implement registration, recordkeeping, financial reporting, and oversight rules with respect to registered credit rating agencies. Exchange Act Rule 17g-1 (17 CFR 240.17g-1), and Form NRSRO (17 CFR 249b.300), prescribe the process for a credit rating agency to apply for registration. Rule 17g-1 and Form NRSRO were effective on June 18, 2007, and the other rules, Rules 17g-2 through 17g-6 (17 CFR 240.17g-2 through 17g-6), became effective on June 26, 2007.<sup>2</sup>

In particular, Rule 17g-5(c)(1) prohibits an NRSRO from issuing or maintaining a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue equaling or exceeding 10% of the total net revenue of the NRSRO for the fiscal year. In adopting this rule, the Commission stated that such a person would be in a position to exercise substantial influence on the NRSRO, which in turn would make it difficult for the NRSRO to remain impartial.<sup>3</sup>

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<sup>1</sup> Pub. L. No. 109-291 (2006).

<sup>2</sup> Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33564-65 (June 18, 2007).

<sup>3</sup> Id. at 33598.

## **II. Application and Exemption Request of LACE Financial Corp.**

LACE Financial Corp. (“LACE”), a credit rating agency, furnished to the Commission an application for registration as an NRSRO under Section 15E of the Exchange Act for the classes of credit ratings described in clauses (i) through (v) of Section 3(a)(62)(B) of the Exchange Act. Based on the information provided in the application, LACE has a conflict of interest relating to the fourth class<sup>4</sup> that would cause the firm to be in violation of Rule 17g-5(c)(1) if LACE became registered. Specifically, for the fiscal year ending December 31, 2007, LACE maintained credit ratings on asset-backed securities solicited by a person that provided LACE with 10% or more of its total revenues for that year.

LACE has requested that the Commission exempt it from Rule 17g-5(c)(1) on the grounds that the prohibition hinders its ability as a small entity to grow its business issuing credit ratings on asset-backed securities. LACE indicated in its application that it expects the percentage of revenue attributable to the relevant client to decrease based on LACE’s revenue trend, continued growth, and the problems in the asset-backed securities market.

## **III. Discussion**

The Commission, when adopting Rule 17g-5(c)(1), noted that it intended to monitor how the prohibition operates in practice, particularly with respect to asset-backed securities, and whether exemptions may be appropriate.<sup>5</sup> The Commission notes that the revenue in question was earned by LACE before it submitted its application for

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<sup>4</sup> The fourth class of credit ratings is for “issuers of asset-backed securities (as that term is defined in section 1101(c) of part 229 of title 17, Code of Federal Regulations...) (“asset-backed securities”). Section 3(a)(62)(B)(iv) of the Exchange Act.

<sup>5</sup> Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).

registration and in the year before Rule 17g-5 was adopted, which limited the time for LACE to adjust its activities to conform to the requirements of the Rule. In addition, the Commission recognizes that, given LACE's size, it is more likely that the firm would be affected by Rule 17g-5(c)(1) than a larger credit rating agency with a more diversified client base. Further, the Commission notes that LACE has stated that it expects that the percentage of total revenue provided by the client will decrease. Finally, the Commission notes that the threshold in Rule 17g-5(c)(1) is, of necessity, a bright line, but activities that exceed that threshold may or may not necessarily raise the concerns that are the basis for the rule. Hence, the Commission believes that it is important for the Commission to consider for each application the specific facts and circumstances of the applicant and whether to grant an exemption from Rule 17g-5(c)(1). Moreover, in this instance, the Commission recognizes that granting this exemption furthers the primary purpose of the Rating Agency Act, which is to enhance competition in the highly concentrated ratings industry. Granting LACE registration in the asset-backed security class will increase the number of NRSROs registered in this class, which could increase competition.

For these reasons, the Commission finds that granting LACE an exemption from Rule 17g- 5(c)(1) for calendar year 2008 is necessary and appropriate in the public interest and is consistent with the protection of investors.<sup>6</sup> The exemption will expire on January 1, 2009 (LACE's fiscal year ends on December 31, 2008). The Commission believes that providing LACE with the opportunity to be registered in the asset-backed security class during this time frame is an appropriate approach to addressing the unique

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<sup>6</sup> Section 36 of the Exchange Act authorizes the Commission, by rule, regulation, or order, to conditionally or unconditionally exempt any person from any rule under the Exchange Act, to the extent that the exemption is necessary or appropriate in the public interest and is consistent with the protection of investors. 15 U.S.C. 78mm.

circumstances of a small credit rating agency, while balancing this against the goal of Rule 17g-5(c)(1)--to prohibit a conflict that has the potential to influence a credit rating agency's impartiality. Consequently, this exemption is conditioned on LACE disclosing in Exhibit 6 to Form NRSRO that the firm received more than 10% of its net revenue in fiscal year 2007 from a client that paid it to rate asset-backed securities. This disclosure is designed to alert users of credit ratings to the existence of this specific conflict.

Simultaneously with this Order, the Commission is issuing an Order granting the registration of LACE with the Commission as an NRSRO under Section 15E of the Exchange Act.<sup>7</sup>

#### **IV. Conclusion**

Accordingly, pursuant to Section 36 of the Exchange Act,

IT IS HEREBY ORDERED that LACE Financial Corp. is exempt from the conflict of interest prohibition in Exchange Act Rule 17g-5(c)(1) until January 1, 2009, provided that LACE Financial Corp. discloses in Exhibit 6 to Form NRSRO that the firm received more than 10% of its net revenue in fiscal year 2007 from a client that paid it to rate asset-backed securities.

By the Commission.

Nancy M. Morris  
Secretary

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<sup>7</sup> Release No. 34-57300 (February 11, 2008).